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May 8, 1997

Federal Communications Commission
Office of Secretary

Ex Parte

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Room 222
Washington, D.C. 20554

Re: CC Docket No. 96-150, In the Matter of the Telecommunications Act of 1996:
Accounting Safeguards Under the Telecommunications Act of 1996

Dear Mr. Caton:

In accordance with Commission rules, please be advised that yesterday, May 7, 1997, Mr. Pat Doherty and the undersigned representing SBC Communications Inc. spoke with Mr. Jose Rodriguez, Mr. Andy Multz, Ms. Alicia Dunnigan, Ms. Valerie Yates, Mr. Thad Machinski, Ms. Kim Yee and Mr. John Hays of the Accounting and Audits Division. The matters discussed are reflected in the attached material, which was handed out at the meeting, and in the comments filed in these proceedings by SBC on (1) exogenous costs and Part 64 and (2) the accounting treatment of certain types of incidental interLATA services.

An original and one copy is being submitted. Acknowledgment and date of receipt of this transmittal are requested. A duplicate transmittal letter is attached for this purpose. Please include this letter in the record of this proceeding in accordance with Section 1.1206(a)(2) of the Commission's Rules.

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Mr. William F. Caton

May 8, 1997

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Due to the lateness of the conclusion of the meeting, this letter is being filed with your office today. If you desire further information, please contact me at (202) 326-8894.

Sincerely,



Attachment

cc: Mr. Rodriguez (w/attachment)
Mr. Mulitz (w/attachment)
Ms. Dunnigan (w/attachment)
Ms. Yates (w/attachment)
Mr. Machinski (w/attachment)
Ms. Yee (w/attachment)
Mr. Hays (w/attachment)

**Southwestern Bell
Accounting Safeguards
CC Docket 96-150**

Incidental InterLATA

- Order treats incidental interLATA as nonregulated for accounting purposes.(Para 75)
- Results in grouping regulated and nonregulated services together.
- Violates the distinction set out in the Joint Cost Order.
 - Joint Cost Order(Para. – 70) "All activities that are classified as common carrier communications for Title II purposes will be classified as regulated activities for purposes of our accounting rules and nonregulated activity cost allocation rules."
- **Tariffed** services such as SS7 and classroom video will be considered **nonregulated!**
- In essence, this will create price regulated services (tariffed) that are considered to be nonregulated.
- The Act (Sec. 271(h))only requires that incidental services "not adversely affect telephone exchange service ratepayers or competition in any telecommunications market".
 - The tariff process will fulfill this requirement.
- The tariff process (and the associated cost support reviews) by definition should stem cross subsidies; treating regulated services as nonregulated makes no sense.
- InterLATA regulated costs/revenues are assigned to the interexchange basket in Part 36 which can not subsidize other baskets e.g. special access or switched.
- How will the Commission deal with conflicting treatment of these services in the state.
 - Many of these tariffed services will be regulated **intrastate** services.
 - What does it accomplish to identify signaling services as nonregulated if states were to continue to identify this as a regulated intrastate service for purposes of jurisdictional classification?
- Conclusion - - Do not reclassify regulated incidental services as nonregulated for purposes of jurisdictional accounting treatment.
 - If services are tariffed then nonregulated treatment is unnecessary.
 - If services are not Title II services, then they will be treated as nonregulated anyway in accordance with the Joint Cost Order.

**Southwestern Bell
Accounting Safeguards
CC Docket 96-150**

**Exogenous Treatment of Reallocated Costs
Only Applies to Investment Forecasts**

CC Docket 96-150 Order

- Order states in paragraph 265 that exogenous changes should accompany costs that are reallocated from regulated to the nonregulated activities in keeping with 61.45(d)(1)(v).
- Part 61.45(d)(1)(v) - Exogenous cost changes shall include (v) the **reallocation of investment** from regulated to nonregulated activities pursuant to Part 64.901.
 - Part 64.901 – Which passage is relevant ????
 - Part 64.901(b) – In assigning or allocating costs to regulated and nonregulated Activities, carriers shall follow the principles described herein.....(1) tariffed services... (2) directly assigned... and (3) costs that cannot be directly assigned.
or
 - Part 64.901 (b)(4) – The allocation of central office equipment and outside plant **investment** costs between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment.....

Part 61.45 Refers Only to Forecast Situations, Part 64.901(b)(4)

- The reference to **investment** can only be linked to (b)(4).
- The reference to cost **reallocation** can only be linked to (b)(4).
 - Joint Cost Recon Order – Para. 15 – In order to assure proper allocation of long-term **investment** to new nonregulated services, we required that central office equipment and outside plant **investment** be allocated based on forecast...
 - Joint Cost Recon Order – Para. 64 – The **cost reallocation requirements** adopted in the Order serve to deter manipulative underforecasting of nonregulated usage and to mitigate the impact on ratepayers of unintended or unavoidable underforecasts.
 - Joint Cost Recon Order – Para. 64 – In short, the **reallocation rules** are essential to the integrity of a cost allocation system which requires cost allocations, like their associated investment decisions, to be made in anticipation of network usage, and which seeks to prevent regulated activities from absorbing nonregulated costs.

- Cost reallocation rules are only found in the rules in one place which is 64.901(b)(4)..
- Exogenous changes pursuant to Part 61.45(d)(1)(v) can only be needed when the cost reallocation rules of 64.901(b)(4) are applicable. They are applicable only upon an underforecast of nonregulated usage of COE and OSP investment by a carrier. This rule then requires a reallocation of investment based upon a correct usage calculation.
- Reallocation of costs to be treated as exogenous were originally defined as associated specifically with forecasting. (Paragraphs 171-172 of Second Report and Order, CC Docket No. 87-313, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers-See attached)
- The Commission rejected a broad application of Part 61.45(d)(1)(v) in the Annual 1991 Access Tariff Order.
 - MCI's suggested exogenous adjustments were determined to be outside the ambit of Part 64.901.

Practical Problems in Implementation

- Initiating exogenous changes predicated on **ongoing** cost shifts from regulated to nonregulated is unworkable from a practical standpoint.
 - Costs are constantly shifting back and forth on a month to month basis based on the multitude of usage based calculations in the CAM process.
 - This seesaw allocation of costs will ratchet down access rates over time.
- **Conclusion** – Exogenous changes should take place upon the occurrence of an underforecast of nonregulated usage of network investment as explained in the Joint Cost Orders.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)
)
Policy and Rules Concerning Rates) CC Docket No. 87-313
for Dominant Carriers)

SECOND REPORT AND ORDER

Adopted: September 19, 1990 ; Released: October 4, 1990

By the Commission: Commissioner Duggan concurring in part and dissenting in part and issuing a separate statement.

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2) Lower formula adjustment mark

164. We reject the assertion by some LECs that the price caps plan must allow an upward PCI adjustment whenever a LEC has experienced for one year earnings below the level at which we might reasonably have prescribed the authorized rate of return for non-price caps carriers. In our view, an incentive plan, if it is to truly motivate carriers to break habits formed by "cost plus" regulation, must present more than an opportunity for gain if efficiencies are realized; it must also present the risk of reduced earnings if the carrier fails to control costs and become more efficient. There would be little such risk if the adjustment mark were set at the prescribed rate of return. Therefore, we will select a level that is below the level of earnings available under traditional rate of return regulation, yet not so low as to cause a confiscatory result in the short term. We also view it as desirable for the formula adjustment mark and the top of the no-sharing zone to be symmetrical, because such symmetry will provide an equal balance of risk and reward over the range of results that we deem likely in the initial period of our LEC price caps plan.

165. We have determined that the no sharing zone should extend to 12.25 percent. If we set the formula adjustment mark symmetrically, it will be 10.25 percent. This level is below the range we have identified for the interstate access cost of capital in the Represcription Order, but still within the range of costs of capital for other public utilities. It is also above the marginal cost of long term telephone debt, which is currently just under 10 percent. Such a return is not likely to be confiscatory, because it should still allow most companies to continue to attract capital and maintain service. We therefore conclude that a formula adjustment mark of 10.25 percent will provide the proper balance of incentives and safeguards to our price caps plan. As we have indicated elsewhere, LECs also retain the opportunity to demonstrate on a case-by-case basis that an adjustment in their allowed rate levels will be necessary to prevent a confiscatory outcome.

5. Exogenous costs.

166. Exogenous costs are in general those costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers. As stated in the Second Further Notice, these are costs that should result in an adjustment to the cap in order to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates.¹⁷⁰ These costs are created by such events as separations changes; USOA amendments; changes in transitional and long term support; the expiration of amortizations; and the reallocation of regulated and nonregulated costs.

¹⁷⁰ See Second Further Notice, 4 FCC Rcd at 3187 (para. 645).

Commenting parties sought to add to this list. We discuss below our reasons for treating certain costs as exogenous.

a. Separations changes

167. As with AT&T, we will require an exogenous cost adjustment for changes in interstate costs for LECs that are caused by changes in the Separations Manual. As we explained in the Second Further Notice, these changes are imposed by regulators and are outside the control of carriers.¹⁷¹ We disagree with Allnet's comment that separations changes should be viewed as a cost of doing business and should not affect the cap.¹⁷² Regulatory decisions that are designed to produce just and reasonable rates must affect the cap in order to ensure that the system results in rates that are just and reasonable.¹⁷³

b. USOA amendments; GAAP changes

168. Changes in LEC costs that are caused by changes in Part 32 of our Rules, the Uniform System of Accounts (USOA), will be considered exogenous.¹⁷⁴ We make this classification on the basis that such changes are imposed by this Commission and are outside the control of carriers.¹⁷⁵ However, carriers are not authorized to adjust their price caps automatically to reflect changes in generally accepted accounting principles (GAAP).¹⁷⁶ As explained in the Second Further Notice, certain GAAP changes may require amendment to the USOA while others may not. Carriers must notify us of their intention to apply a change in GAAP and we will allow such change if we find it to be compatible

171 Second Further Notice, 4 FCC Rod at 3011 (para. 280).

172 Allnet Comments at 13.

* 173 To prevent excessive rate churn, carriers will not be permitted to adjust their PCIs to reflect changes in certain exogenous costs at the time these changes occur. Instead, they will be permitted to adjust their PCI to reflect these changes only once a year on July 1. Such costs are: (1) changes in long term support; (2) changes in transitional support; (3) changes in Subscriber Plant Factor (SPF); and (4) changes in Dial Equipment Minutes (DEM). See Appendix B at 61.45(d) (3).

174 47 C.F.R. §§ 32.1 et seq.

175 Accord Executive Agencies Comments at 7; Ohio PUC Comments at 13.

176 GAAP changes are adopted by the Financial Accounting Standards Board (FASB).

for changes in transitional and long term support will be required to demonstrate the quantitative impact in tariff filings.

d. Reallocation of regulated and nonregulated costs

171. We agree with those commenters that argue that exogenous cost treatment of investment reallocated from regulated to nonregulated use is necessary to give effect to the Joint Cost rules¹⁸² in a price cap environment.¹⁸³ These rules require carriers to allocate common plant investment between regulated and nonregulated activities in accordance with a three-year forecast of relative regulated and nonregulated use. The rules are intended to protect ratepayers from the investment risk associated with a carrier's nonregulated businesses by excluding from that carrier's rate base both plant investment currently used for nonregulated purposes and spare capacity intended for future nonregulated use. We note that no party objects to the characterization of these costs as exogenous.

172. As explained in the Second Further Notice, under rate of return regulation, these required reallocations translate into reductions in rate base and regulated cost, that in turn produce reductions in regulated rates.¹⁸⁴ However, under the price cap plan, reallocation of regulated investment to nonregulated activities would not impact interstate rates at all. To register the effect of this reallocation in a price cap context, and thus give effect to the Joint Cost rules, we must require an exogenous cost adjustment to be made whenever regulated investment is reallocated to nonregulated activities.

e. Expiration of amortizations

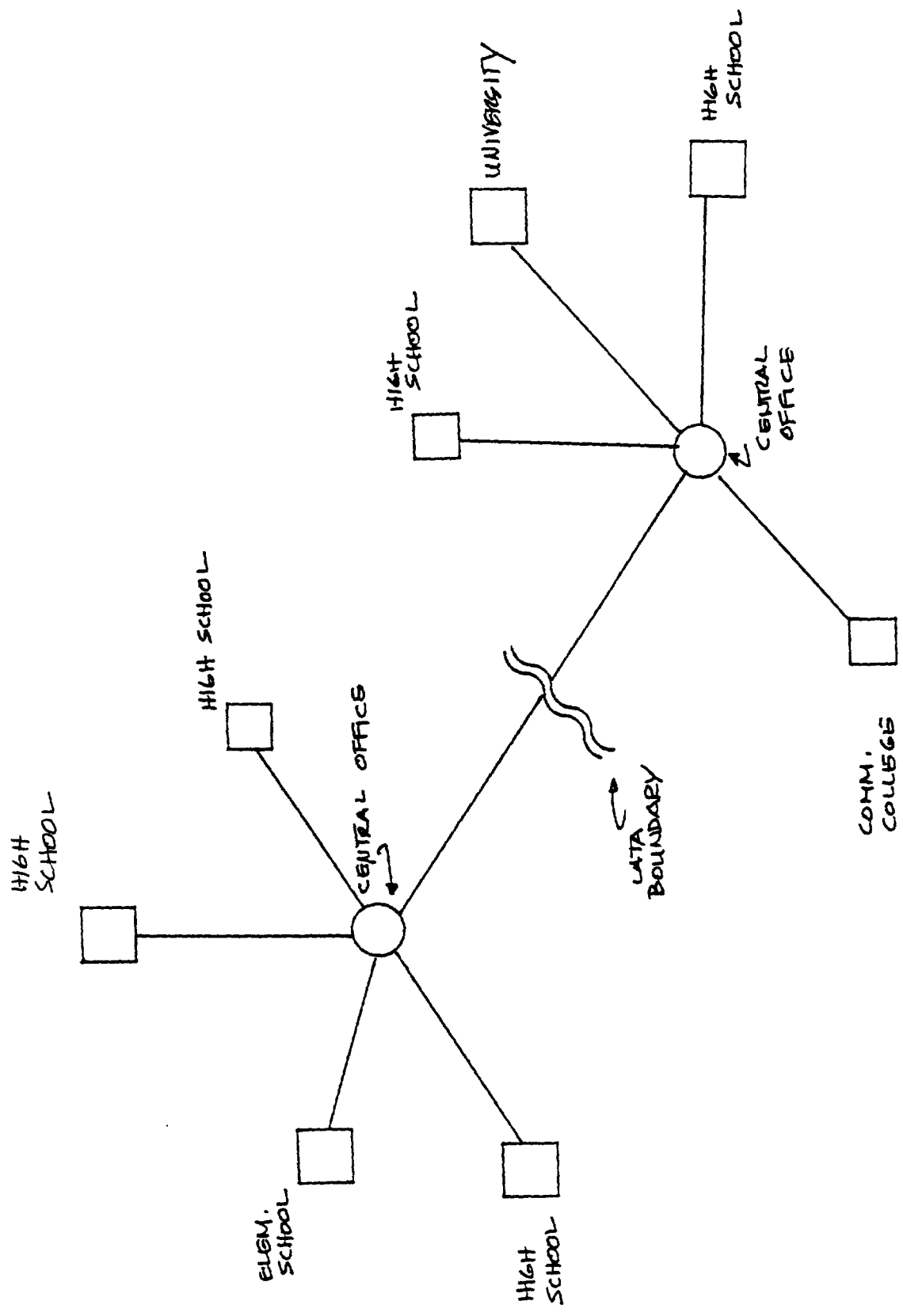
173. We find that expirations of amortizations to correct existing depreciation reserve deficiencies, which under rate of return would create downward pressure on rates at the time the amortizations expire, should be considered exogenous costs under price caps, as some parties argue.¹⁸⁵ As we stated in the Second Further Notice, it would be unfair to ratepayers who are

182 47 C.F.R. § 64.901.

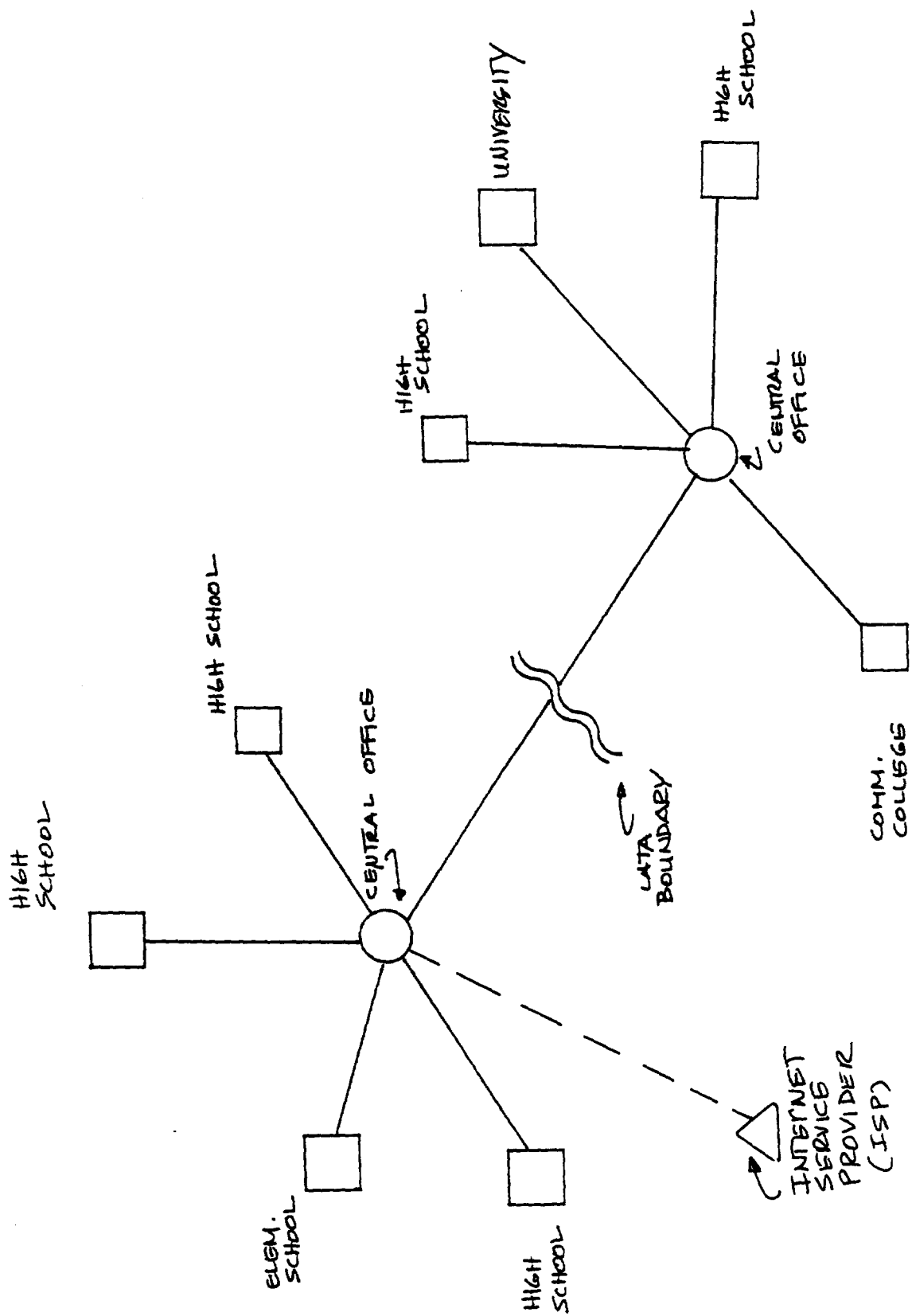
183 See, e.g., Alabama PSC Comments at 4; Ohio PUC Comments at 13; Michigan PSC Staff Comments at 5.

184 See Second Further Notice, 4 FCC Rcd at 3019 (para. 301).

185 See, e.g., Executive Agencies Comments at 7; Rochester Comments at 4; NY DPS Comments at 11-12; Ohio PUC Comments at 13.



EXAMPLE A
(VIDEO)



EXAMPLE B
(INTERNET SERVICE)

MM 87-268

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March 11, 1997
Raymond L. Heard
13209 N.E. Shaver
Portland, OR 97230

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U.S. Communications Commission
Office of Secretary

EX PARTE OR LATE FILED

Dear Sir:

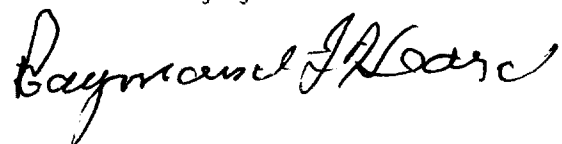
I see on the news today that the FCC is going to vote on authorizing a new digital technology for TV. I understand that if they implement that scheme our present TV's will be obsolete. The news said that TV's to handle this new technology would cost from \$1000 to \$1500 more than the present sets and the two systems wouldn't be compatible. That would mean that I would have to replace my existing TV and VCR or I wouldn't have any TV at all. I am opposed to this scheme and don't want the FCC to approve it.

Between my motorhome and my house I have 4 color TV's and two black and white sets, and 3 VCR's located in various convenient areas of my house. I don't want any of them to be rendered obsolete because of this crazy idea. They say that the pictures would be much clearer. I am on the cable and now receive some 40 plus channels. Of these I watch a couple of news channels, OPB, the discovery channel, occasionally a sports channel (racing and golf), and some movies. The morals of the junk on all the other channels is appalling. If they're not killing people, beating the hell out of people, or having sex; they are flooding the channels with offers to sell me everything from soap to high risk commodities like Hog Bellies or grain futures. I don't need to be forced by my government agency that's charged with the responsibility to govern these things into buying one new high priced TV and one new high priced VCR to replace my comfortable collection of equipment. I don't need higher resolution TV's pictures of Newt Gingrich lying on TV. Or higher resolution TV pictures of soap ads or Sanitary pad ads.

The current political trend now seems to be toward a free market society. If this is such a good proposal then let the free market reign. I think the fact is that the backers of this new system know that in competition with the current system they don't stand a chance. The consuming public given the opportunity to purchase either the current TV's or a new TV system for \$1500 hundred dollars more per TV would overwhelmingly retain their present system. I think that is why the backers of this system want the FCC to mandate this change by law because that's the only way they can get this crazy idea through.

It wouldn't surprise me to find out that the orientals and Chinese that were buying influence to our political system might just be the ones seeking this change.

Sincerely yours



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